

The Company contends that the sharing orders and the AFOR settlement simply do not address tax consequences, and contends that it must be included now because failure to do so would violate federal law and because ratepayers are not harmed by the partial offset of deferred taxes.

The Commission agrees with Staff that it is appropriate to pro form the effect of the 1993 Sharing dollars into the calculation. However, the Commission must conclude that there should be a tax effect given to these adjustments. The Commission is, however, concerned that the Company's presentation in previous proceedings does not disclose the full nature of these adjustments to accumulated depreciation.

In fact, in two documents of which official notice is taken, a Commission Staff report and a USWC response that led to the 1991 Sharing Order, the following exchange occurred. In Commission Staff's Additional Comments in Response to the Commission's June 6 letter to parties, at page 5, the Commission Staff set out an amortization chart showing the amortization of the depreciation sharing dollars. The chart does not reflect a deferred tax offset. If a deferred tax offset were made, the figures on the chart would be incorrect.

In USWC's response to the Commission Staff comment, the Company at page 6 acknowledges that the Commission Staff proposal would limit the Company to an 11% rate of return. However, as proposed by Commission Staff, the Company's return may well have been held below 11%. The sharing dollars represent the excess revenues, not the excess net operating income. As such, flow-through just to the depreciation expense without a tax offset would have reduced the Company's earnings below the 11%.

Consequently, it appears that it is appropriate to offset the accumulated depreciation with deferred taxes. The Commission recalculates this adjustment based on Ex. 164. The effect of the adjustment is a decrease in rate base of \$31,035,616.

B. Sale of Rural Exchanges, PFA-7; SA-6

In Docket No. UT-940701, the Commission accepted a settlement agreement involving the sale of 28 rural exchange properties formerly operated by USWC in Washington State. One element of the settlement was USWC's pledge to credit depreciation reserve with \$16.6 million.

USWC proposes a pro forma adjustment, PFA-7, to give effect to both the removal of the now-sold exchanges and to recognize the disposition of the gain as agreed to in the settlement agreement. One part of adjustment PFA-7 would pro form an offsetting amount for accumulated deferred taxes to the accumulated depreciation credit of \$16.6 million. This is similar to USWC's proposal regarding the Sharing Dollar depreciation adjustment. USWC contends that the Internal Revenue Code requires the taxes to be recorded in this manner for ratemaking purposes.

Commission Staff opposes the adjustment. It contends, through Mr. Zawislak, that the settlement agreement does not mention and does not contemplate this offset. Commission Staff argues that the Company's proposal would deprive ratepayers of the benefit of the bargain that the Commission approved. Public Counsel/TRACER urge that the Commission adopt the same approach to this adjustment that it adopts to the Sharing adjustment, next above.

The Commission finds that the circumstances presented here differ from those of the Sharing order. Here, although we have an order that contemplates no offset, we have no pleadings that indicate parties' intent. We have no subsequent orders, and the remedy, effecting the proper tax treatment, is more easily accomplished.

The Company suggests that the credit to the depreciation reserve is the result of a charge to depreciation expense. Thus, per tax regulations, it is necessary to credit deferred taxes and as a result decrease accumulated depreciation and accumulated deferred taxes. However, the Company adjustment does not show an amount for deferred tax expense. The lack of entries associated with depreciation expense is explainable in that the credit to the reserve was by agreement in the settlement, and as with the gain on the sale of the exchanges, is not part of the pro forma adjustment. This is not to say, however, that the depreciation is not related to operations. The same is not true for the deferred taxes. The stipulation made no mention of credits to deferred taxes. The Company's failure to pro form the deferred tax credit is inconsistent with its position that the deferred taxes must be recognized for this depreciation entry.

While the Commission is not certain whether Commission Staff's position would violate the tax code, the Commission will accept the Company's contention in this proceeding. The Commission however, will complete the adjustment and include the credit to deferred tax expense.

The Commission is concerned that the Company negotiated the settlement on the gain on the sale of rural exchanges without revealing the full expected tax consequences of its position, failing to disclose or to make adjustments when timely, then taking no responsibility for consequences when tax implications of the agreement became clear. The Company has an affirmative obligation to disclose such matters to regulators.

The effect of this adjustment is to increase net operating income by \$4,210,071 and decrease rate base by \$43,542,000.

C. Pension Asset RSA-16

In prior years, the Company over-accrued sums for future pensions, resulting in a pension asset. The Commission Order in Docket Nos. UT-930074/930307/931378 ordered that the Company prospectively flow through the tax consequences of the pension asset. The Company as part of adjustment RSA-16 proposes to remove the previously-deferred taxes from the rate base. USWC contends that the previously deferred amounts were flowed through in the sharing proceedings in 1993 and 1994, and that Commission Staff accepted the entries.

Commission Staff contends that this is an adjustment without substance, arguing that there were no sharing dollars available in 1994. The Company, urges Commission Staff, affords no benefit to ratepayers in this adjustment. Commission Staff proposes instead to pass the benefit of the taxes back to ratepayers over three years, merely making them whole, and preventing the inequity of allowing the Company to benefit from its own booking errors.

The Commission finds that the situation before us results from a Company error, namely, the Company's previous deferral of amounts that should have been flowed through. The Commission finds that it is appropriate to correct it, as suggested by Commission Staff.

Further, the commission order in dockets UT-930074, et al., stated that, "The commission will continue to offset rate base by the unamortized deferred taxes associated with the pension asset.... In either case, ratepayers are given full credit for the deferred tax expense recognized in rates, which has not been paid or obligated to the federal government."

The Commission will adopt in principle Mr. Twitchell's adjustment regarding the deferred taxes associated with the pension asset. That treatment is consistent with the referenced order and with WAC 480-120-031, which requires flow through of these tax benefits. The Commission is aware that the Company did flow through the tax benefits associated with the year 1993 in the sharing proceeding. Therefore, the Commission will only amortize the deferred taxes accumulated through 1992, i.e., \$19.4 million on an intrastate basis as determined from Exhibit 323. As a result the Commission rejects the Company's proposed rate base adjustment to remove the entire deferred tax of \$22.1 million, and instead revises it to \$9,137,758. This amount represents the removal of one year's amortization and the net amounts accrued on the books in 1993 and 1994.

Review of this issue leads the Commission to greater concern about the filings in the Sharing proceedings. The fourth page of Exhibit 323 is a listing of the uncontested adjustments in the 1993 sharing proceeding. On line 16, the adjustment RA-19 Pension Asset Tax Effect shows an increase to rate base of \$22.2 million. If this \$22.2 million is the deferred taxes of the pension asset, then this adjustment is in direct violation of the excerpt quoted above, which required the deferred taxes to be treated as an offset to rate base.

D. System X Deferred Tax Difference, RSA-16

The Company's separated results of operation contain a current item designated System X deferred Tax difference. Mr. Twitchell, a Commission Staff witness, proposes to remove the item. He states that he asked the Company for an explanation of this item, and that the Company was unable to explain sufficiently what these taxes were. Thus, Mr. Twitchell proposes to remove this item.

Commission Staff argues that this item is included in the Company's tax calculation for regulated operations simply as a plug to balance the separated income tax expense with the total Company level. The Company provides no reconciliation of total regulated taxes to regulated net operating income. Without such a demonstration, Staff recommends that the amount not be allowed.

Ms. Wright on rebuttal blames Mr. Twitchell for the disagreement, contending that his failure to understand this accounting entry should be no reason to disallow this expense. She states that the item is a balancing line. She says that taxes are calculated on a total basis, monthly, and that the balancing line is needed for system X because there is a timing difference between the unregulated calculation and the total calculation. The system X is therefore simply a self-correcting entry made to balance the total income tax expense. She further explains that the large \$6 million amount was for the most part a result of the November 1993 balancing, which reflected a September 1993 depreciation represcription.

The Company argues that the Staff admits that it does not know whether this adjustment is appropriate. They argue that taxes are calculated in total for USWC and then allocated to the various regulatory identifications, including unregulated. They note that the detail from each of the units is not synchronous. They point out that the line item is simply a balancing line used in the allocation due to the asynchronous detail, and that it is ultimately self-correcting. The major portion of the system X item was recorded in November 1993 associated with a September 1993 entry associated with depreciation represcription.

Commission Staff, through Mr. Twitchell, asked for details of the calculation that would enable him to check it. He did not receive the requested information -- except the explanation that it was a figure inserted to make calculations balance.

On brief, the Company runs through its calculation and states that because the four regulatory separations processes governing the calculation are not synchronized, it is necessary to insert a filler that the Company calls a "reconciling adjustment." The Company supports the number with the contention that it is reasonable because the taxes removed are proportional to total company taxes as deregulated products are to company total income. The Company on brief again accuses the Commission Staff of "lack of understanding". The Company contends that lack of understanding is not substantial evidence that would support the Commission Staff position.

The Commission finds that the Company's explanation is insufficient to allow independent calculation of its adjustment. It finds that the Company inserted the number to make the results balance. It finds that proportionality of the tax is not sufficient to verify the number, as taxes are not shown to be a constant proportion to revenues. The Company provides no evidence that the tax calculation for the regulated operations, absent this balancing amount, is incorrect.

Further, Exhibit 158 refers to an unusually large entry in September 1993 that, when coupled with the asynchronous tax calculations between regulatory units, caused a large entry in November 1993. September 1993 is outside the test period, and test year entries to true up such amounts are not properly representative of test year expenses.

The Commission concludes that the Company has not met its burden of supporting this adjustment, and that it should be disallowed. This is a part of Adjustment RSA-16.

E. Federal Income Tax True-Ups, RSA-7 and RSA-17/OOP-4

The Company proposes these two adjustments to adjust the test year expense for out of period entries. RSA-7 adjusts the test year for an entry in the books made subsequent to the test period but reflective of the test period costs. RSA-17/OOP-4 removes a true up that was booked during the test period but reflective of 1992 costs.

Commission Staff objects to the Company's calculation of these two adjustments in two respects. First, Staff observes that the Company allocates the current tax portion of these true-ups at 41.9% to intrastate. Mr. Twitchell argues that these amounts should be allocated consistently with the underlying revenue and expense, approximately 72%, which would be similar to the allocation of other tax elements. The Company does not explain why there is such a discrepancy in the various allocators. It argues that it is difficult at best to determine the underlying revenues and expense. The Commission will adopt Staff's position on this issue because the Company fails to explain the discrepancy.

The second difference that Commission Staff argues is that the deferred tax adjustments related to pre-test year results should not be included in rate base. The Company contends that the Staff is making an inappropriate adjustment because all prior adjustments should be reflected in the account for end-of-period calculation.

Here, the Commission finds that the Company is correct. Using the end-of-period totals is appropriate, and the balance sheet is unaffected by the difference between an entry in 1992 and those in 1993.

F. Tax Effect of AFUDC, RMA-3

This Company-proposed adjustment is intended to restate the test year rate base and depreciation expense associated with Allowance for Funds Used During Construction (AFUDC) accrued in a side record related to short term Construction Work in Progress (CWIP).

Commission Staff proposes to offset the Company's adjustment with deferred taxes based upon its theory that depreciation of AFUDC must generate a reduction in deferred taxes. The Company responds that in order to have a tax effect of depreciation there must be revenue. It cites Ms. Wright's testimony that nonoperating revenues generated these deferred taxes, and it

reasons that because the deferred taxes were "below the line", depreciation of the AFUDC cannot generate above-the-line deferred taxes. The Commission finds that the Company's explanation is correct.

The Commission accepts the Company's adjustment to its side record, which drew no objection, and finds that the Commission Staff-proposed adjustment to deferred taxes is inappropriate.

G. Interest Synchronization, C-16.

Public Counsel/TRACER witness Carver proposes an interest synchronization adjustment, generally referred to as pro forma debt in prior Commission orders, to pro form the effect of the Commission's authorized weighted cost of debt on the Company's Federal Income Tax (FIT) expense. His adjustment determines a level of pro forma interest by multiplying his pro forma rate base times Mr. Hill's weighted cost of debt.

Mr. Carver notes the absence of an interest synchronization adjustment in Staff's case. He states that it is important to adjust the interest expense effect on the level of interest that the ratepayer is required to pay through the rate of return.

Staff accepts this adjustment in principle, with one modification. That modification is to include interest on CWIP as part of pro forma interest. Public Counsel/TRACER accept the Commission Staff revision for the inclusion of CWIP in the calculation.

The Company argues that it is inappropriate to use a hypothetical capital structure and therefore it is inappropriate to make a pro forma adjustment to interest. The Company's argument appears groundless. Even the Company's original weighted cost of debt was based on a capital structure and cost of debt from one point in time and not exactly equal to test year averages. Further, as Mr. Carver testified (TR 2416-2417), USWC had unamortized investment tax credit on its books during the test period. Investment tax credits are not subtracted from rate base, as are accumulated deferred taxes. USWC as an "option 2" company under tax regulations is allowed to earn its authorized return on the unamortized portion of these credits. The return is to be equal to the overall return found appropriate by this Commission. As Mr. Carver testified, the regulator is allowed to synchronize the tax benefits of the assumed interest costs allowed to USWC. Therefore, in order to represent correctly the tax benefits of interest to be paid for by the ratepayers, and allowed by current tax regulations, the Commission accepts Mr. Carver's proposed adjustment. The Commission has recalculated this adjustment based on the findings in this record, and the effect is an increase to NOI of \$4,925,548.

Commission Staff proposed to include CWIP in the calculation of pro forma interest. The Commission notes that there is no testimony supporting Staff's modification. The Commission is aware that in many previous orders CWIP was included in the calculation to the

extent companies were not required to capitalize interest for tax purposes. As there is no evidence to support this modification in this proceeding, it follows that the Commission will exclude CWIP from the calculation.

Excluding CWIP from the calculation raises the concern of how tax benefits of interest on construction will be flowed through to the ratepayers. In this proceeding only, the Company will be authorized to normalize the tax benefits of interest associated with CWIP, if they exist, by accruing AFUDC on projects when interest is not capitalized for tax purposes, at the authorized return net of tax rather than at the authorized return. This is the same method used to calculate the allowance for funds used to conserve energy (AFUCE) for Puget Sound Power and Light.³⁹

H. Uncontested Adjustments

The following adjustments are uncontested and are accepted as portrayed: Adjustments RMA-1, 2, and 4 through 7; RSA-4, 6, 8, 9, 11, and 15; RSA 17-OOP-1, 3, and 5 through 8; PFA-12; and SA-10.

VI. RATE BASE

The parties disagreed on a number of matters relating to calculation of the Company's proper rate base for regulatory purposes. The differences are shown in the Table attached to this Order as an Appendix, as set out in Public Counsel's brief.

A. Working Capital Adjustments PFA-3, PFA-4, PFA-5, & SA-7

The Company proposes three components of working capital: pension asset, cash working capital (lead lag study), and materials and supplies.

1. Pension Asset

The Company proposes to include the pension asset as a discrete item in rate base. Ms. Wright discusses the pension asset adjustment, PFA-3, which increases rate base by \$69.9 million.

Ms. Wright says that the pension asset is created when the Company credits pension expense, because the pension fund is larger than the pension liability. This asset has been created since the Financial Accounting Standards Board (FASB) adopted SFAS 87, a statement of principle on pension accounting. The Company argues, as it did in Docket No. UT-930307, that credits to expense have been flowed through to the net operating income used in the sharing proceedings and general rate analysis.

³⁹ See, WUTC v. Puget Sound Power & Light, Cause Nos. U-90-1183 and -1184, 3d and 4th Supp. Orders.

Commission Staff opposes including a pension asset in rate base at all. It argues that the pension asset should not be allowed to earn a return twice, once in the pension fund and once in the rate base.

The Commission accepts the Company position on this adjustment. All of the return earned in the fund is used to reduce the need for further investment by the Company, and thus it works to reduce the pension expense. That was the Company's position in Docket No. UT-930307. The Company's proposal appears to be consistent with the prior order. The order in that docket states that the Commission does not question the prudence of the asset, and that the reason for rejection at that time was merely that it should be examined in conjunction with a total working capital analysis such as the one presented in this proceeding.

2. Lead-Lag or Investor Supplied Working Capital Study

The Company proposes a lead-lag analysis to measure working capital. Ms. Wright's analysis, summarized in Exhibit 199 shows a negative working capital of approximately \$5 million. However, when combined with the direct inclusion of the pension asset (\$70 million) and material and supplies (PFA-5, \$4.7 million) she contends that the total working capital at current rates is nearly \$70 million. For comparison, Ms. Wright also presents a calculation of working capital using the approach accepted by the Commission in the most recent Puget Power general rate case. That analysis (see Exhibit 157) reveals a working capital of \$135.6 million. This analysis was not performed on a total company basis but rather on a Washington State basis to be consistent with Mr. Cummings, the Company's cost of money witness.

Mr. Zawislak presents Commission Staff's calculation of Investor Supplied Working Capital (ISWC), adjustment SA-5, which would replace Company adjustments PFA-3, -4, and -5, Pension Asset, Cash Working Capital, and materials and supplies. These adjustments are all related to the working capital issue. The Company included the pension asset and materials and supplies directly in rate base, and then calculated cash working capital through the use of a lead-lag study. Mr. Zawislak calculated working capital using the investor-supplied approach. His approach includes materials and supplies in working capital, but his calculation removes the pension asset from working capital and thus from rate base in total. The Company's calculation of total working capital is \$70 million, while Staff's is a negative \$46 million, for a difference in rate base of \$116 million.

The major difference between the Company and the Commission Staff in working capital is related to Staff's exclusion of the pension asset, discussed above. The remainder of the difference is embedded in the calculations and the difference in methods. Mr. Zawislak also compares his ISWC approach to the method proposed as a check by Ms. Wright in her Exhibit 157, and contends that Ms. Wright's calculation is based on an incomplete Washington State balance sheet, that in fact does not balance. He contends that it is pieced together from different sources. His working capital calculation is based on total USWC financial statements.

The Company argues that the ISWC approach may be used only when Commission Staff demonstrates that a company's lead-lag study is inadequate. It contends that its ability to present the ISWC study is severely limited by the fact that USWC does not maintain jurisdictional balance sheets. It argues that the Commission Staff approach does not account for differences between jurisdictions in capital recovery policies, authorized rates of return, or taxation (contending that states that rely on sales taxes will have smaller working capital adjustments than states relying more on property taxes). It urges that the lead-lag approach will avoid the problems with the Commission Staff ISWC methodology.

Commission Staff argues that the ISWC methodology is superior because it provides a comprehensive review of all items in a total investor supplied working capital analysis, consistent with the Commission's January, 1995, order in Docket No. UT-930074, resolving USWC's petition to implement FCC and Financial Accounting Standards Board accounting for post-retirement benefits. Commission Staff contends that the Company analysis is incomplete and Ms. Wright's ISWC "test" is based on a hypothetical balance sheet that was not in balance prior to the calculation. It accepts lead-lag studies in concept, but opposes the Company's proposal.

The Commission accepts the Commission Staff approach to working capital in this proceeding. The Commission believes that it is more comprehensive and more accurate than the lead-lag approach. It allows the calculation to take place in the context of a balance sheet analysis of company performance rather than examining limited factors. While we understand the Company's situation, not having a readily available Washington balance sheet to work from, we believe that the additional accuracy gained from making the effort to prepare the balance sheet outweighs the expedience available in the lead-lag study. Consequently, we accept the Commission Staff methodology.

3. Declared Dividends

The Company contends that, if a balance sheet approach is used, the Commission must include declared dividends as an element of invested capital. It reasons that once dividends are declared, they are a liability owed to investors. It cites a leading accounting text in support of its proposition.

Commission Staff merely states that both Company and Commission Staff exclude declared dividends, citing USWC witness Mr. Haack as acknowledging that they are a short-term liability and that the funds are zero cost capital to the company.

The Commission accepts the Company's approach and views declared dividends as investor-supplied capital. The Commission notes that in many previous proceedings concerning other companies (for example, Puget Sound Power and Light), dividends payable were excluded from invested capital. The Commission by this order is not reversing those decisions. The circumstances and evidence provided in this record are different. Most notably, USWC is a subsidiary of USWI, and all dividends are thus payable to USWI at its discretion.

In summary on working capital, the Commission adopts Staff's method of calculating total working capital. The Commission rejects the Staff treatment of the \$529 million pension asset as a non-operating investment. The Commission will treat the \$96.8 million dividends payable as invested capital. As a result, total investor supplied working capital for USWC is \$181 million. The Commission will directly allocate the \$69.9 million pension asset to Washington intrastate operations. The resulting negative balance will be allocated consistently with Commission Staff's calculation in Exhibit 651, for a negative \$37.8 million working capital allocated to Washington. The resulting net working capital is \$32,119,086.

VII. Conclusion and Table

The following table sets out the results of the Commission's deliberations on net operating income and rate base elements.

US WEST COMMUNICATIONS
WASHINGTON INTRASTATE OPERATIONS
TWELVE MONTHS ENDING OCTOBER 1994

LINE NO		COMMISSION FINDINGS NOI	COMMISSION FINDINGS RATE BASE
1	NET OPERATING INCOME & RATE BASE - PER BOOKS	<u>\$89,076,000</u>	<u>\$1,473,014,000</u>
	ADJUSTMENTS:		
2	RMA #1 DEREGULATED MOBILE RADIO	\$276,544	(\$813,085)
3	RMA #2 MERGER EXPENSE	8,797	(239,208)
4	RMA #3 AFUDC (MEMORANDUM IDC)	(2,499,012)	23,140,741
5	RMA #4 POLITICAL ACTION EXPENSE	9,819	0
6	RMA #5 DEPRECIATION REFUND AMORTIZATION	(3,003,288)	16,796,490
7	RMA #6 DEPRECIATION RESERVE	16,905,658	128,295,423
8	RMA #7 FLOW THROUGH OF NON-PROPERTY TAX	801,812	4,547,960
9	RMA #8 OPEB	97,331	(7,036,298)
10	RMA #9 SHARING ADJUSTMENTS	0	(31,035,616)
11	RSA #1 OCCUPATIONAL WAGE ANNUALIZATION	(1,972,844)	0
12	RSA #2 MANAGEMENT SALARY ANNUALIZATION	(747,663)	0
13	RSA #3 RATE REDUCTION	(4,442,152)	0
14	RSA #4 RENT COMPENSATION	(83,000)	0
15	RSA #5 AFFILIATED INTEREST BILLING ADJUSTMENT	1,232,375	0
16	RSA #6 PENSION CREDIT REDUCTION	(740,377)	0
17	RSA #7 FEDERAL INCOME TAX ADJUSTMENT	1,071,554	1,902,019
18	RSA #8 INSIDE WIRE AMORTIZATION	173,885	134,000
19	RSA #9 PRIMARY TOLL CARRIER	(3,929,557)	0
20	RSA #10 CLASSIFICATION ADJUSTMENT	711,913	0
21	RSA #11 PURCHASE REBATE ADJUSTMENT	282,169	0
22	RSA #12 COMPENSATED ABSENCE ADJUSTMENT	390,000	0
23	RSA #13 TEAM & MERIT AWARD ADJUSTMENT	6,384,966	0
24	RSA #14 BENEFIT EXPENSE ADJUSTMENT	711,076	(64,341)
25	RSA #15 PROPERTY TAX RESTATEMENT	84,787	0
26	RSA #16 FLOW THROUGH TAX RESTATEMENT	13,033,193	10,898,426
	RSA #17 OUT OF PERIOD ADJUSTMENTS		
27	OOP #1 PRE-DIVESTITURE TAX ISSUES	(73,855)	0
28	OOP #2 ASSET CLEARANCE	222,024	0
29	OOP #3 ACCOUNT RECONCILIATION	821,489	0
30	OOP #4 INCOME TAX	(496,570)	0
31	OOP #5 PROPERTY TAX	(1,951,422)	0
32	OOP #6 LEGAL SETTLEMENT	(197,320)	0
33	OOP #7 INDEPENDENT COMPANY	894,215	0
34	OOP #8 PURCHASE REBATE	(1,227,247)	0
35	PFA #1 OCCUPATIONAL WAGE INCREASE	(3,381,860)	0
36	PFA #2 MANAGEMENT SALARY INCREASE	(1,482,081)	0
37	PFA #3 PENSION ASSET	0	69,915,604
38	PFA #4 CASH WORKING CAPITAL	0	0
39	PFA #5 MATERIAL AND SUPPLIES	0	0
40	PFA #6 CAPITAL RECOVERY	5,049,375	1,165,240
41	PFA #7 RURAL SALES	4,210,071	(43,542,000)
42	PFA #8 AMORT. OF DEBT CALL PREMIUM EXPENSE	539,257	0
43	PFA #9 RESTRUCTURING ADJUSTMENT	11,408,953	(11,766,524)
44	PFA #10 OPEB CURTAILMENT LOSS	0	0
45	PFA #11 INTERCONNECTION WITH INDEPENDENTS	0	0
46	PFA #12 POSTAGE	(449,476)	0
47	SA #1 YELLOW PAGES	50,934,378	0
48	SA #2 HELD ORDERS	0	0
49	SA #3 JURISDICTIONAL SEPARATIONS	6,805,250	(35,722,831)
50	SA #4 MARKET RESOURCE GROUP	1,052,896	0
51	SA #5 INVESTOR SUPPLIED WORKING CAPITAL	0	(37,796,518)
52	SA #6 RURAL SALES SETTLEMENT	0	0
53	SA #7 BRI	2,374,375	0
54	SA #8 ADVERTISING ADJUSTMENT	0	0
55	SA #9 REGULATORY FEE (COMPANY OOP #9)	178,682	0
56	SA #10 CHARITY CONTRIBUTIONS	0	0
57	SA #11 EXTERNAL RELATIONS	338,911	0
58	SA #12 OVERTIME AND CAPITALIZATION	0	0
59	C-1 RECURRING REVENUE	9,508,000	0
61	C-16 INTEREST SYNCHRONIZATION	4,925,548	0
62	C-11 OCCUPATIONAL ANNUALIZATION	0	0
63	C-12 MANAGEMENT ANNUALIZATION	0	0
64	C-6 BELLCORE DISALLOWANCE	606,000	0
65	C-7 USWAT PROJECT DISALLOWANCE	286,000	0
66	C-8 US WEST INC. CHARGES	0	0
67	TOTAL ADJUSTMENTS	<u>\$115,673,579</u>	<u>\$88,779,482</u>
68	NET OPERATING INCOME ADJUSTED	<u>\$204,749,579</u>	<u>\$1,561,793,482</u>

VIII. Rate of Return

The Company's overall authorized rate of return is calculated by determining the interest rate that the company pays on debt and the investor's required return on equity, then multiplying those rates by the proper proportion of each source of capital in the Company's ratemaking capital structure.

The parties' positions at the conclusion of the proceeding are set out in the accompanying table.

COMPARISON OF RATE OF RETURN CALCULATIONS

	Public Company Cummings	Counsel Hill	Staff Folsom
SHORT TERM DEBT			
Ratio	10.267%	9.100%	9.100%
Cost Rate	6.170%	6.000%	5.390%
Weighted Cost	0.633%	0.546%	0.490%
LONG TERM DEBT			
Ratio	33.167%	38.900%	31.000%
Cost Rate	7.050%	7.200%	7.600%
Weighted Cost	2.338%	2.801%	2.356%
PREFERRED EQUITY			
Ratio	0.000%	0.000%	4.900%
Cost Rate	0.000%	0.000%	8.500%
Weighted Cost	0.000%	0.000%	0.417%
COMMON EQUITY			
Ratio	56.567%	52.000%	55.000%
Cost Rate	12.500%	11.250%	11.55%
Weighted Cost	7.071%	5.850%	6.353%
RECOMMENDED RATE OF RETURN	10.043%	9.197%	9.615%
NET OF TAX	9.003%	8.026%	8.619%

A. Cost of Debt

The calculation of cost of debt is rendered somewhat more complex by additional debt issues after the Company's original case was submitted, and by the Commission's acceptance of Mr. Hill's hypothetical capital structure.

The parties agree that the Commission Staff cost of debt should be used if the Commission accepts the Commission Staff-proposed approach to amortizing debt call premium. As we have done so, above, we accept the Commission Staff cost of debt here for the Company's original case capital structure.

We price the Company's recent additional debt at its actual cost, as derived by comparison of Mr. Cummings' direct and rebuttal presentations.

Finally, based on the total capital in Mr. Cummings' rebuttal case, less Commission Staff's adjustment for debt call premium, we add the additional debt required by Mr. Hill's hypothetical capital structure. We price it at Mr. Hill's proposed cost for new issues -- which is somewhat higher than the rate at which the Company was able to finance its recent issues.

The resulting long term cost of debt is 7.57%. We have adopted Mr. Hill's short term cost of debt at 6% as consistent with the Commission-determined capital structure.

B. Cost of Preferred

The Commission Staff proposed the use of preferred stock in a hypothetical capital structure, and offered a proposed rate. As described below, we accept Mr. Hill's hypothetical capital structure and include no preferred stock in the calculation of rate of return.

C. Cost of Equity

The Commission has reviewed the testimony on cost of equity that has been presented by the parties. We conclude that USWC experiences less risk than USWI and the other regional holding companies (RHCs). We believe that the effect of the lower risk can be measured through the cost of equity and/or the capital structure. The Commission accepts the arguments of Staff witness Folsom and Public Counsel/TRACER witness Hill that the extent of unregulated markets participated in by the regional holding companies creates a higher level of business risk associated with the total operations of the holding companies as compared to the regulated telephone operating companies.

The Commission rejects Mr. Cummings' proposal to use a group of non-telephone comparable companies. The Company's own case argues that Mr. Hill's use of gas distribution companies is not comparable. Those companies have lower bond ratings and higher debt ratios

than are experienced in the telephone industry, facts that should tend to produce equity returns which are higher -- but as argued by Mr. Cummings and admitted by Mr. Hill, the gas companies are generally considered to have lower equity return requirements. So, too, the AA-rated industrial companies have capital structures with approximately 73% equity, yet their bond ratings are no higher than the bond ratings of USWC. The conclusion one draws is that these companies carry greater business risk, and it is difficult at best to conclude that the measurement of these companies' equity capital is comparable to that of USWC.

The Commission concludes, as represented by Mr. Hill, that the gas companies in his sample are of lower risk, and have lower equity return requirements than does USWC. The USWC equity cost rate should be greater than Mr. Hill's findings for this group.

The Commission rejects the use of the independent telephone companies as proposed by Mr. Cummings and Ms. Folsom. The Commission agrees with Mr. Hill that this group of telephone companies displays greater risk by their higher levels of penetration into unregulated markets. Further, the Commission is not convinced that the three-stage growth factor postulated by Ms. Folsom is appropriate, particularly as it relates to these independents.

The Commission finds the discounted cash flow results for the RHCs to be in the range of 11.73% as shown by Ms. Folsom, to 11.86%, shown by Mr. Cummings. As stated above, the Commission agrees with Commission Staff and Public Counsel/TRACER that USWC is of lower risk than the regional holding companies. However, for the most part we believe our authorized capital structure, discussed below, reflects this effect. We find an equity return range centered at 11.8% to measure investor requirements.

The Commission finds no reason to adjust this return for issuance costs as argued by Mr. Cummings. We find Ms. Folsom's arguments convincing that the real costs of issuance would only have a de minimis effect. The range of DCF results by each of the witnesses within the group of regional holding companies is far greater than any proposed effect for issuance costs. Finally, with all stock held by USWI, the actual issuance costs would be negligible.

The Commission finds that Ms. Folsom's range for the regional holding companies is from 11.0 to 12.7%; Mr. Hill's range for those companies is from 11.0 to 12.3% and Mr. Cummings' range is from 11.4 to 12.8%. Each of the witnesses shows a standard deviation of about 50 basis points for the study group's DCF results.

As discussed in the quality of service section, the Commission finds it necessary to provide an incentive for the Company to make improvements in its service quality, by adjusting the Company's authorized cost of equity capital to the lower end of the reasonable range. We find that a 50 basis point adjustment from the center of the range is appropriate to reflect the lack of quality customer service. The Commission thus finds an authorized equity rate of return for USWC in this proceeding of 11.3%.

D. Capital Structure

The Company urges the Commission to accept its actual capital structure of 56.6% equity and 43.4% debt. It contends that no party demonstrates that USWC's capital structure is either unreasonable or uneconomical.

Mr. Cummings supports the Company's actual capital structure. He states that this capital structure is lighter in equity than USWC's target capital structure, but indicates that the Company is not likely to make great progress toward its target of 60% equity in 1995. He points out that this capital structure has more debt and less equity than the average RHC or independent operating company, around 41%.

Ms. Folsom for Commission Staff proposes to modify the Company's capital structure by adding preferred stock in place of some common equity. She contends that the capital structure needs to balance economic risks and costs of shareholder funding with those of debt funding. She states that this Commission has several times in the past adopted just that for USWC or its predecessor, PNB. She states that USWC's actual capital structure, with 59.9% equity, is too rich in equity. She points out that USWC's debt ratio is significantly below the required Standard & Poors AA bond benchmark of 42%, and further that USWC's capital structure includes no preferred stock, which is less expensive than common equity. She indicates that her hypothetical structure still includes a debt ratio of less than 42%. The use of preferred stock adds economy to the capital structure, she suggests, without increased leveraging. Further, Ms. Folsom rejects the concept of double leveraging, as she believes that the change in ownership of the operating company should not affect the cost of capital.

Mr. Hill also proposes a hypothetical capital structure, including 52% equity and 48% debt. He states that the company's actual capital structure, containing 56.6% equity, is excessively rich in equity. He identifies the following capital structures: USW Inc. has 47% equity in its capital structure; USWC regulated 60.29% equity; USWC double leveraged is 52.05%; Value Line Industrials have a 56.3% equity ratio; Value Line Gas have a 50% equity ratio (excluding short term debt); Value Line Gas and Electric are at 44% (before short term debt); and the RHCs have an average 50% equity ratio.

Mr. Hill contends that USW Inc., the RHCs, Value Line's industrial composite, and the independents used by Mr. Cummings in his estimate of common equity costs, all are entities with greater risk than USWC-Washington regulated activities. He argues that in each case, the companies participate in substantially more competitive markets than the USWC regulated Washington operations. He argues that monopoly utility services are perceived as lower risk and the investor requires a lower return than similarly debt rated entities. While Mr. Hill agrees with Staff witness Folsom that the use of a double-leveraged capital structure is not proper, he notes that Ms. Folsom does not analyze impacts of leveraging. He argues that a holding company, such as USW Inc., can financially cross-subsidize its more competitive (therefore more risky) ventures by including more equity in the regulated operation than necessary

for the efficient financing of the regulated operations. He points out that on a regulated basis a 60% or even a 56% equity ratio is substantially higher than the consolidated USW Inc. equity ratio of 47%.

Mr. Hill also looks to the gas industry which, he argues, faces similar risks to those faced by local exchange companies. Despite these similarities, Mr. Hill does not believe that gas distribution companies are perceived to be as risky as the telecommunications industry.

Public Counsel/TRACER argue that Mr. Cummings recommends the use of an actual capital structure without performing an evaluation of the most basic standards: Safety and Economy. They argue that Mr. Hill did present evidence that his recommendations would produce reasonable results. They argue that the Earnings Before Interest and Taxes Plus Depreciation and Amortization (EBITDA) studies are theoretically valid, noting that the company has placed some reliance on EBITDA themselves. They point out that Public Counsel is not recommending \$35 billion in debt, but note that the study indicates the level of safety being experienced by USWC even at a 60% debt ratio. Finally, they argue that the benchmarks of the rating agencies are advisory not absolute.

Mr. Hill cites the gas company equity range of 44-47% to be below the proper ratio for the telecommunications industry and establishes the 47%, also USW, Inc.'s consolidated equity ratio, as the bottom of the range appropriate for a local telecommunications company. He argues that top of the range should be significantly below the Value Line industrials average equity ratio of 56%. He identifies the 52% regulated leveraged equity ratio used to finance USWC and uses it as the top of the range. In this proceeding he chooses the 52% as the acceptable equity ratio. After identifying the 52% equity ratio, Mr. Hill goes on to demonstrate the safety of his proposed capital structure through comparison of earnings before interest and taxes to the company's total interest expense. His comparison also includes interest as if the Company had been only 40% equity financed.

Mr. Hill states that the use of preferred stock, as proposed by Ms. Folsom, does not achieve the desired goal that she stated. He indicates that while the market cost is similar to long term debt rate, the tax implications make preferred substantially more expensive than debt. He also states that the use of preferred stock is not common in the telephone industry.

Mr. Cummings opposes Mr. Hill's proposed capital structure. Mr. Cummings contends that Mr. Hill's reliance on financial reporting capital structures is inappropriate, and that the use of the financial reports is not in agreement with the investment used for ratemaking. He argues that Mr. Hill's proposed capital structure is inconsistent with the risk associated with the company's AA bond rating and looks more like an A or BBB rated company. Mr. Cummings argues that Mr. Hill's cross-subsidization argument uses inconsistent data, namely financial reporting for U S WEST, Inc, versus regulatory structure for USWC. He also argues the reverse, that is, use of Mr. Hill's capital structure, may result in cross-subsidization of USWC. With respect to Mr. Hill's safety analysis, Mr. Cummings states that the results simply produce

unreasonable results. He argues that the level of debt (\$35.5 billion) assumable under Mr. Hill's analysis would produce results that could not be considered financially safe by rating agencies or investors.

The Company argues that Mr. Hill's references to financial reporting capital structures of his comparable companies is improper and that regulatory capital structures should have been used, instead. Public Counsel/TRACER respond that the regulatory capital structure is 52% equity, adjusted for parent company leverage, is an example of the excess of the company's actual structure.

Conclusion: In reviewing capital structure,

The Commission's function is to set as the appropriate capital structure for ratemaking purposes that structure which best balances economy with safety. (WUTC v. Continental Telephone co. of the Northwest, Cause No. U-81-14, 2d Supp. Order (1981).)

The Commission accepts Mr. Hill's analysis and his proposed hypothetical capital structure. We find that Mr. Hill's proposal best balances safety with economy. We find that the existing capital structure is unreasonable and unwise for the company and that it so unreasonably and substantially varies from usual practice as to impose an unfair burden on the consumer.

We find it significant that US WEST Inc can set the Company's capital structure at whatever level best fits with its larger corporate objectives, rather than whatever is the best balance between debt and equity for both business and ratepayer concerns for USWC as a stand-alone company.

Mr. Hill's proposal is supported by comparable data and it is shown to be both economical and safe by earnings volatility tests.

E. Commission's Rate of Return/Capital Structure

<u>Type of Capital</u>	<u>Ratios</u>	<u>Cost Rates</u>	<u>Weighted Costs</u>
Long term debt	38.9000%	7.570%	2.945%
Short term debt	9.100%	6.000%	0.546%
Preferred equity	0.000%	0.000%	0.000%
Common Equity	<u>52.000%</u>	11.300%	<u>5.876%</u>
TOTAL	100.000%		9.367%

IX. Revenue Requirement Determination

Pulling together the financial elements of this Order, the following table shows the calculation of the Company's revenue requirement.

In calculating the Company's revenue requirement, it is necessary to use a conversion factor to account for such factors as taxes, to derive the number of pre-tax revenue dollars needed to produce the required net operating income. The parties' briefs do not state that there are disagreements as to the appropriate conversion factor to use. Consequently, we use Mr. Hua's proposed factor in this calculation.

Derivation of Revenue Requirement

Pro Forma Rate Base	\$1,561,793,482
Authorized Rate of Return	9.367%
Return Requirement	<u>\$ 146,293,195</u>
Pro Forma Net Operating Income	<u>\$ 204,749,579</u>
Net Operating Income Deficiency (Surplus)	<u>(\$ 58,456,384)</u>
Conversion Factor Multiplier	1.565458
Revenue Deficiency (Surplus)	<u>(\$91,511,013)</u>

PART FIVE:
RATE DESIGN ISSUES

I. Policy

The parties agree that the policy factors that are most significant are those set out in Chapter 80.36 RCW, especially those in RCW 80.36.300.⁴⁰ The Commission keeps those factors in mind as it reviews the issues and makes its decisions on individual elements of this proceeding and on this matter as a whole. In particular, the statutory goal of universal service is a significant element of Washington State policy goal. It underlies many of the parties' arguments, particularly those of Public Counsel/AARP for achieving low residential exchange rates. USWC has contended that universal service may be maintained despite substantially higher residential local exchange rates than exist at present.

Universal service remains a primary and continuing Washington State policy. The Commission notes the existence of a pending docket aimed specifically toward exploring the meaning of universal service in a changing economic and regulatory environment (Docket No. UT-950724). The Commission will make no close examination of universal service in this proceeding. First, the other cause is pending and its scope will go substantially beyond the issues as they are framed in this matter, and second, by virtue of the revenue reduction that we find to be required we are not faced with rate increases that might threaten the existing universality of local exchange service. The topic will be addressed in the pending proceeding.

The principal policy issue that the parties chose to address is competition -- the role of competition in transitional regulation, the correct response of a regulated utility to encounters with competition, and even whether "competition" as each party defines it exists.

⁴⁰ The statute reads as follows:

80.36.300 Policy declaration. The legislature declares it is the policy of the state to:

- (1) Preserve affordable universal telecommunications service;
- (2) Maintain and advance the efficiency and availability of telecommunications service;
- (3) Ensure that customers pay only reasonable charges for telecommunications service;
- (4) Ensure that rates for noncompetitive telecommunications services do not subsidize the competitive ventures of regulated telecommunications companies;
- (5) Promote diversity in the supply of telecommunications services and products in telecommunications markets throughout the state; and
- (6) Permit flexible regulation of competitive telecommunications companies and services.

(1985 c 450 § 1).

Throughout the proceeding the Company has contended that it is beset with competition on all sides and that the Company should be permitted to set prices as though marketing issues were the predominant criteria. Time and again, it supported proposed pricing not by factors involving cost, but by factors involving marketing.

The Company contends that the goals of this proceeding are to establish a realistic revenue requirement for USWC and to rebalance rates to reflect competitive realities. The Company argues that need exists now, not in the future, and it contends that failure to respond is potentially unlawful and confiscatory. It bases its rate restructure principally on the need to meet market requirements.

Commission Staff, however, responds that USWC vastly overstates the existence of and near term prospects for competition. It urges that the level of competition that exists today is not strong enough to substitute for regulation in constraining prices and providing customers choices.

Commission Staff cites Mr. Selwyn's suggested goals for the transitional environment: (1) minimize duplication by requiring resale and unbundling; (2) promote entrants' efficient use of the existing network; (3) promote development of networks through private investment so competitors have comparable risks and rewards; (4) promote greater responsiveness to specialized needs than feasible for a single provider -- i.e., encourage "niche" providers. The Commission finds that these goals are appropriate, and it has considered them in its rate design deliberations.

Public Counsel/AARP contend that the Commission should "expose the fiction" that residential rates are subsidized, and make a specific finding that residential rates are not subsidized. The Commission believes that the evidence is overwhelming that local exchange service does cover its total service long run incremental costs (TSLRIC) -- even as calculated by the Company in its Average Service Incremental Cost (ASIC) presentation -- and makes that clear in its discussion of residential rates, below.

Public Counsel/AARP contend that USWC has alleged that it faces competition but that it has not presented objective evidence on market share, market power, or the existence of price-constraining competition. The Commission finds this to be true, and it observes that this is one of the central factors in the result of this proceeding. It is uncontested that some entrants are preparing to provide or are providing competitive services. It is also uncontested that the future holds many unknowns. Cable television providers may package two-way telecommunications with one-way programming services. Wireless services may supplant rather than supplement wire-based communications in the future. Internet-based services may provide a viable alternative to measured toll service. The future presents a multitude of options, any or many of which may ultimately take a significant share of the Washington State telecommunications market.

But USWC has presented no credible evidence that the future is upon us to the extent that we may shift regulatory focus from costs to market-based pricing. USWC made no showing that the nascent competition of which it presented anecdotal evidence has the power to constrain prices. The Commission anticipates that at some point, it will indeed be necessary to shift regulatory focus from costs to market prices -- but that point requires the existence of effective competition that can constrain prices. USWC can achieve a shift toward market pricing by securing competitive classification of particular services through the statutory mechanisms for doing so -- which requires a demonstration that the service is subject to effective competition. The Company could negotiate or seek approval of an AFOR in which pricing flexibility is granted and earnings regulation relaxed as part of a larger agreement.

We are sensitive to USWC's situation and its concerns. We find our Order to be consistent with the transitional market that now exists and with sound preparation for competitive markets. We also will authorize the Company to file banded rates for any service that it believes is likely to face competition. Banded rates provide as much pricing flexibility as the law -- and our duty to protect captive customers -- permit. See, RCW 80.36.340.

Public Counsel/AARP ask the Commission to end USWC's use of "black box" cost studies by announcing a number of specific cost study requirements; the Commission will address those matters below.

The Department of Defense/Federal Executive Agencies (DOD/FEA) argues that the federal government needs viable competitors for its contracting policies to work effectively to save the government money. The Commission believes that its actions in this order do promote the development of effective competition in a way consistent with both State and Federal law. DOD/FEA cite to the recently-enacted Federal Telecom Act and its role in advancing implementation of effective competition for local exchange service.

The Washington State Department of Information Services argues that the Commission should promote competition (or at least do nothing to hinder competition). Again, we believe that our actions are consistent with advancing competition in a way consistent with law and all parties' rights. WITA, the Washington Independent Telephone Association, asks the Commission to consider policy choices from the perspective of all players so that clear and appropriate signals are sent. We have done our best to do so in this Order.

II. Cost Studies

This case is the first in which this Commission has attempted to measure on a systematic and consistent basis the costs incurred by USWC to provide various services. There has been remarkably little debate about the need to measure service-specific costs as one element of determining reasonable and sufficient rates. Nor has there been great disagreement that costs should be measured from the ground up, i.e., on a long-run, incremental, going-forward basis and without consideration of the actual costs incurred in the past by USWC.

The degree of consensus about the need to do cost studies and the need to do them on a long-run incremental basis is in stark contrast with the lack of consensus about the specifics of the cost calculations. Parties disagree about virtually every aspect of the cost study process, notably about what constitutes an incremental cost, what costs should be included in a study, and what analytical model should be used to calculate costs.

In addition, while there is general agreement about the need for studies, there is substantial disagreement about what should be done with cost studies. The parties do agree that rates for individual services should not be set below incremental cost so as to have one service subsidizing another service. Many parties identify particular services that they believe should be priced at or very near incremental cost. Some parties acknowledge, and the Commission finds, that setting all rates at incremental cost would not produce enough revenue to meet USWC's revenue requirement, which is determined on the basis of its embedded costs. Except for USWC's flawed Average Direct and Shared Residual Cost (ADSRC) calculations, no party offers a systematic approach to reconciling the revenue requirement of the firm with the incremental costs of individual services.⁴¹

To address the contested issues regarding methodology and cost study inputs, it is important first to state clearly the purpose to which the end product will be put: The Commission will use incremental cost studies primarily to establish price floors for individual services. When USWC introduces a new service or seeks to lower the rates for an existing service, it is important to ensure that the rates at least cover the incremental costs of providing that service. Guarding against cross-subsidy and predatory pricing is the primary function of the incremental cost studies.

The Commission will use incremental cost studies secondarily to guide and inform its decisions on rate spread in this case. No party has suggested any sort of mechanistic relationship between incremental costs and rates, such as an equal percentage markup over incremental costs, and any such formula would appear to be inappropriate. It could, for instance, result in rates for some services that would exceed the revenue-maximizing level. It would be foolish to set rates so high that the service actually produces less revenue than it would at a lower rate. Neither are rates based on equal markup over incremental cost necessarily fair. An equally "fair" rule, with potentially very different rates, would be to have equal discounts from the stand-alone cost of each service.

⁴¹ The record also is silent as to the appropriate price ceilings for various services. Incremental costs provide a theoretical price floor for each service: the price of a service should at least equal the costs that the firm would not incur if it were to cease providing the service. If prices are set lower than incremental cost, other firms could be prevented from entering the market, even if they have lower costs than USWC. The price ceiling, by contrast, would be defined as the costs that a firm would incur if it were to provide a particular service on a stand-alone basis. Local exchange service, for example, should not be priced above the cost of building a stand-alone network of loops and switches dedicated solely to local service. Public Counsel argues that the price ceiling for local service is obtained by including the local loop in the cost of local service. The Commission does not accept this argument, because it assumes without factual basis that other shared and common costs would be avoided in a local-only network.

Incremental cost studies provide one more useful tool in determining fair, just, reasonable, and sufficient rates for individual services, but they do not in themselves determine those rates. Other considerations, such as the traditional factors discussed by TRACER,⁴² remain an important part of the rate-setting process.

A. Methodology

USWC's cost studies measure Average Service Incremental Cost (ASIC), Shared Residual Cost (SRC), and Average Direct and Shared Residual Cost (ADSRC). The main points of contention are whether and how to account for shared costs; whether to include the cost of the loop in the incremental cost of one or more services; and what analytical model to use.

The Commission finds, consistent with the presentations of most parties that addressed cost issues, that the appropriate measure of costs is Total Service Long Run Incremental Cost (TSLRIC). The Commission has found this measure of costs to be appropriate in prior cases.⁴³ Incremental costs are appropriate because they measure the additional costs that are incurred by providing an additional service. TSLRIC therefore represents the economic price floor. If the revenues from a service exceed the TSLRIC of that service, then that service is not being cross-subsidized. If the firm were to stop providing that unit, its revenues would fall by more than its costs.⁴⁴

1. Inclusion of Shared Residual Costs

The Commission rejects the concept proffered by USWC of incremental costs that include what it labels variously as "shared," "family," or "group" costs. USWC's cost studies measure Average Service Incremental Cost (ASIC), Average Shared Residual Cost (ASRC) and Average Direct and Shared Residual Cost (ADSRC) in the following relationship:

$$ADSRC = ASIC + ASRC$$

⁴² The cited elements are the following:

1. Effectiveness in yielding total revenue requirements under the fair return standard; 2. Fairness in the apportionment of total costs of service among different consumers; and 3. Efficiency in discouraging wasteful use of services while promoting all justified types and amounts of use, in view of the relationships between costs incurred and benefits received.

⁴³ Notably, these are the orders in the "term loops" case, 4th Supplemental Order, Docket No. UT-930957, et al., and in the Interconnection case, 4th Supplemental Order, Docket No. UT-941464. The Commission acknowledges that the latter order remains involved in post-order process.

⁴⁴ Having prices exceed their respective TSLRICs is a necessary but not sufficient condition in determining whether those prices are fair, just, reasonable, and sufficient. That determination requires consideration of a much broader set of factors than the TSLRIC of the service.

The Commission agrees with Staff, Public Counsel, and others who argue that ADSRC is not a relevant measure of the economic cost of providing a service. ASIC is the element in USWC's studies that most closely approximates TSLRIC. Inclusion of SRC in incremental cost results would allow USWC to manipulate costing concepts to suit its pricing purposes. It could assign more of the shared costs to services that have captive customers.

USWC contends that ADSRC, while not the economic price floor, is a useful measure for setting prices of individual services. It urges that pricing at ADSRC ensures the recovery of shared residual costs from the group of services that share the SRC. It contends that under almost no circumstance should a service be priced at ASIC, the theoretical price floor. If the Commission chooses to ignore the ADSRC in declaring cost floors, argues USWC, the shared and common costs must nonetheless still be recovered in prices.

The Commission agrees that shared and common costs, if they qualify as a part of the Company's revenue requirement, must be considered in setting rates. It does not follow, however, that doing so requires that rates be set at ADSRC. The ADSRC value may be useful to USWC's management as a pricing target, and there is nothing wrong with its use as a management tool when it prices unregulated services. It should not, however, define either the floor or the target for regulated ratemaking.

2. Inclusion of the Local Loop in Incremental Cost Studies

USWC includes the cost of the local loop in its calculation of the TSLRIC of local exchange service. According to USWC, allocation of any loop costs to access and toll service violates the principle of incremental costing, because the entire loop cost would exist even if no carrier access or toll services were provided.

Public Counsel/AARP argue that USWC has significantly overstated the incremental cost of local exchange service by including the cost of the local loop, which they assert is not incremental to local service. Their argument is that the loop would be required to offer virtually every other service besides local exchange service and, therefore, that the cost of the local loop is not incremental to local exchange service. Since the loop is required if USWC is to provide any one of toll service, access service, or local service, it is incremental to none of the services.

The Commission finds, consistent with the presentations of Public Counsel/AARP, and other parties that the cost of the local loop is not appropriately included in the incremental cost of local exchange service. The local loop facilities are required for nearly every service provided by the Company to a customer. Neither local service nor in-state long distance service nor interstate long distance nor vertical features can reach a customer without the local loop. Should USWC cease to provide any one of these services, its need for a local loop to provide the remaining services would remain. The cost of the local loop, therefore, is not incremental to any

one service. It is a shared cost that should be recovered in the rates, but no one service is responsible for that recovery. USWC's presentation that the local loop is appropriately and necessarily an element of the cost of local exchange service, made through the testimony of witness Farrow, is not credible in light of the purposes of a long run incremental cost study and is inconsistent with accepted economic theory regarding such studies.

USWC argues that allocation of any loop costs to access and toll service violates the principle of incremental costing, because the entire loop cost would exist even if no carrier access or toll services were provided. This argument addresses why loop costs should not be included in the incremental cost of toll and access, but it does not explain why they belong in the incremental cost of local service. The argument applies equally well in application of the costs to local exchange service. Indeed USWC's brief supports the principle that the loop is a shared cost rather than the direct cost of any one service:

All multi-service firms have shared and common costs by definition, but they are particularly significant for a LEC, which offers very capital and expense intensive local services which require a separate loop from the central office to every premise in its service territory... (USWC brief, 11).

Our conclusion that the local loop is correctly treated as a shared cost is consistent with the testimony of USWC's cost witness Brian Farrow, who testified:

U S WEST recommends that the Commission deal with the recovery of loop costs as a pricing exercise. The loop costs calculated in U S WEST's cost studies calculate the loop costs as though the loop is the cost object. The recovery of those costs is a pricing exercise. (Ex. T-338, p. 14).

Commission Staff offered a different approach to the treatment of loop costs in incremental cost studies. Staff argued that the cost of the loop should be allocated to services that use the loop based on a formula adopted by the Commission in Docket No. U-85-23. In that case the Commission said that loop costs should be recovered 25% from interstate toll, 16.95% from intraLATA toll, and the remainder, 58.05%, from local service. Thus staff's calculation of the incremental cost of local service includes 58.05% of the cost of the local loop. Commission Staff argues that the loop costs are not part of the incremental cost of local exchange service but are allocated to local exchange and toll service because of the Commission's past orders. Staff contends that the assignments adopted in U-85-23 were reaffirmed in the recent interconnection order, where the Commission said:

[T]he residential cost study contains a basic flaw: USWC improperly allocates 100% of the local loop to residential service, and 0% to services that rely and depend on the use of that facility.